American Bankers Association
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November 24, 2010

Mr. Robert E. Feldman
Executive Secretary
Attention: Comments
Federal Deposit Insurance Corporation
550 17th Street, N.W.
Washington, D.C. 20429

Re: RIN 3064-AD63; Assessment Dividends, Assessment Rates and Designated Reserve Ratio; 12 CFR Part 327; 75 Federal Register 66272, October 27, 2010

Dear Mr. Feldman:

The American Bankers Association appreciates the opportunity to comment on the Notice of Proposed Rulemaking (proposal) on Assessment Dividends, Assessment Rates and Designated Reserve Ratio. ABA represents banks of all sizes and charters and is the voice for the nation's $13 trillion banking industry and its two million employees.

In the wake of the most costly bank failure cycle since the Great Depression, it is very appropriate that FDIC consider a long-term strategy to assure it has the adequate funding for future economic downturns. We share the goal of a having a financially strong fund so that insured depositors in our banks will have complete confidence that their money is safe. As the full cost of the FDIC – including personnel, administrative, examination, and bank failure costs – is borne by the banking industry, the decisions made by FDIC today will have direct consequences for banks and the communities they serve many years into the future. Finding an appropriate balance that meets the agency's financial needs yet does not impose undue financial hardship on banks and their communities is critical.

Therefore, the ABA believes that it is important that there be a set of principles to guide the long-term funding strategy, including the following:

- The FDIC insurance fund should only be for the protection of insured depositors;
- Low, steady, and predictable premiums should be set that do not fluctuate with the business cycle, thus avoiding premium spikes;
- An upper limit should be set on the size of the FDIC insurance fund; and
- The FDIC should establish a dividend policy to slow the growth of the insurance fund as it approaches the upper limit and to ensure that the FDIC does not accumulate resources significantly above what are needed to protect insured depositors.

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In addition, because it is critical to achieve a balance between adequate funding and keeping resources in banks' communities, we believe the pace of growth of the fund is as important as the ultimate level that is achieved. This will determine the premium assessment rates banks must pay at any given time. We believe the FDIC should use the full time period set by Congress to reach the newly established 1.35 percent minimum. The FDIC should monitor the progress toward rebuilding the fund and adjust premiums downward should the fund be growing faster than expected. After that is achieved, we believe it appropriate to reduce the premium rate to the long-term low level and build the fund at a more modest pace to assure that the maximum resources remain in banks' communities.

Furthermore, the long-term target reserve ratio (the Designated Reserve Ratio) set by FDIC must reflect changes in law and regulation – such as the Dodd-Frank Act and the Basel III capital regulations – that lower the probability of failure and lower the cost of those banks that do fail. These changes necessarily mean that past experience cannot be wholly relied upon as a predictor of future FDIC needs and that the level of funding necessary to weather another economic downturn is lower than it would need to be in the absence of them. If not, then the risk mitigation provisions of the Dodd-Frank Act and the Basel III exercise would have to be assumed to be failures. It is troubling that such an obvious factor for determining the long-term level of the fund was not considered by the FDIC in its analysis. Thus, the 2.00 percent minimum reserve ratio proposed is far too high given these changes.

Moreover, allowing the fund to grow even beyond 2.50 percent extracts large amounts of funds out of communities. Such high levels of funding add little to the protection of the FDIC, while those same dollars left to be used in local communities can be an enormous boost to small businesses looking to start or expand their operations.

The FDIC must also consider the implications of its decisions on its member banks in relation to credit unions insured by the National Credit Union Share Insurance Fund (NCUSIF). Both FDIC and NCUSIF provide identical protection for bank and credit union depositors. NCUSIF, however, is limited by statute to a reserve ratio of 1.50 percent. Thus, setting an FDIC Designated Reserve Ratio significantly higher (as FDIC proposes) than this limit on NCUSIF could create costly disparities that could exacerbate government-created competitive imbalances. There needs to be consideration of these conditions and the consequences if a significant gap is created between the long-term funding levels of these two insurance funds.

Before turning to more detail on these points, there is one additional issue not directly related to the proposal, but that needs to be addressed: the issue of returning to banks excesses in prepayments resulting from the pronounced decline in FDIC resolution costs and from the Dodd-Frank Act mandated shift in the premium assessment base. We would also note that the prepayment assumed the three basis point premium increase beginning in 2011 which the FDIC has recently rescinded. These changes have created marked differences in what the FDIC has already collected and what can reasonably be expected as actual assessed

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payments. We recommend that the FDIC take action by no later than December 31, 2011 (and preferably sooner) to return excess prepayments to banks. This should enable the FDIC to maintain the necessary cash levels required for bank failures next year (under the FDIC's projections for fewer bank failures next year) and free up this non-interest-earning asset on banks' books. The FDIC should ***not*** collect any additional prepayments from banks that will pay more under the new broadened assessment base. These banks will be paying much higher premiums due to the broadened base and will do so at the time of billing once their prepayment balances are exhausted. To require further prepayments now would put an extra and unnecessary burden on these banks, a burden which would no longer be required for meeting FDIC's cash needs.

The remainder of the comment letter will discuss core principles, the pace of growth of the fund to achieve the minimum and long-term reserve ratios, concerns with the proposed designated reserve ratio, and the potential unintended consequences of disparate levels of funding for banks and credit unions.

I. Long-Term Principles

The FDIC Insurance Fund Should Only Be Used for the Protection of Insured Depositors

Since the FDIC was created in 1933, the banking industry has borne all its financial obligations. This historical role that focuses on bank safety and soundness and on protecting the interests of insured depositors in the event that an insured depository institution fails must be preserved. Every cent in the insurance fund comes from premiums paid by banks and interest on the accumulated balance of those premiums. Therefore, the fund and the interest it generates should be used to solely in fulfillment of this mandated role of the FDIC.

Bankers are particularly concerned that a very large fund will becomes a honey pot for funding other activities that are not directly related to the protection of insured depositors. Such attacks on the fund could come from legislated diversion of funds or they could come from mission creep at the FDIC itself, expanding into areas beyond its role as deposit insurer. For example, the insurance fund should not be used to assist or resolve any failures of non-FDIC-insured depository institutions.

Low, Steady, and Predictable Premiums Should Be Set in Long-run

ABA supports the FDIC's goal to assess low, steady, and predictable premiums over the long run. That includes avoiding periods when no premiums are paid as well as avoiding spikes in premium levels. We appreciate that the proposal anticipates moving to a low premium structure at some reserve ratio. However, we strongly believe that the ***FDIC should not set rates such that the reserve ratio continues to grow without limit.*** Rather, premium rates should be set to maintain the reserve ratio of the fund at a constant, low, reasonable level. Moreover, as will be discussed more fully below, we believe the proposal provides too

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aggressive a level of premiums and a lower level could be set sooner that will still allow the fund to grow to a reasonable level. Past experience has shown that the FDIC's resources tend to grow more quickly than projected during periods of economic recovery.

An Upper Limit Should Be Set on the Size of the FDIC Fund

The banking industry acknowledges in light of the recent experience that the previous Designated Reserve Ratio of 1.25 percent was inadequate and we accept that the FDIC seeks a higher long-run target ratio is appropriate – ***but an unreasonable one or an open-ended one that leads to an unlimited fund must be carefully avoided***. In fact, the industry strongly holds that there must be some upper limit on the size of the fund. Higher premiums to support a larger fund mean fewer funds available to support bank capital and the various financial services that banks provide to their communities. Such a limit also acts as a means of discipline, encouraging the FDIC to use its resources wisely.

The FDIC Should Establish a Dividend Policy to Slow the Growth of the Insurance Fund as it Approaches the Upper Limit

The dividend policy under the 2006 law was designed as an automatic breaking system to slow the growth of the fund as it approach an upper limit. While reducing premium rates to a low and steady level will go a long way to manage the growth of the fund (and we agree should be the first line of defense against excessive growth), past experience teaches that interest income ***alone*** (particularly in periods of low or even negative deposit growth) could well exceed the FDIC's expenses and keep the fund growing even after it reaches optimal levels. Such was the case in the second half of the 1990s when few banks failed. Such a circumstance would not be unusual in periods of economic growth and with a healthy banking industry. When interest income is combined with premiums paid, the result could be a very rapid growth of the fund. Thus, some dividend mechanism should be established and maintained as an additional tool to slow or even arrest the growth of the fund at some predetermined level.

The dividend policy also can work hand-in-hand with the risk-based premium system. For example, a system could be structured that would return higher dividends to lower-risk institutions (even returning dividends in excess of their quarterly payments). This would enable premiums to be paid each quarter by all banks, but would essentially allow a negative premium in order to bring the fund back to some designated level or to keep the fund from rising above an upper level. Of course, careful management of premium rates should be sufficient to keep the fund below the upper limit.

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II. Use the Full Time Frame for Recapitalization and Then Lower Premiums to Long-Run Rate

The FDIC should use the full time frame authorized under the Dodd-Frank Act to bring the insurance fund to 1.35 percent by September 30, 2020, and then keep premiums low and steady premiums to bring the fund to any higher target ratio over time. This keeps the maximum amount of funds in local communities while assuring progress toward the mandated minimum level and on the time frame set by Congress.

We believe that the FDIC's forecast for how quickly the reserve ratio recovers is too pessimistic. If the rate of bank failures and costs mirror the pattern following the failure cycle in the early 1990s, we expect the fund to reach the 1.35 percent level by mid-year 2017.[1] In fact, using this same pattern and FDIC's proposed rate reductions, we expect the reserve ratio to reach 2.00 percent (without reducing rates as we recommend) by 2021 – just a year after the statute requires the fund to be at 1.35 percent. ***We believe such unnecessarily high rates and such an aggressive time table does not appropriately balance the needs of the FDIC with the economic impact on banks and their communities.***

Already there is evidence that failure costs are significantly lower than previously projected. The FDIC recaptured $2.5 billion in reserves that it had set aside for possible bank failures in the second quarter and recaptured another $3.8 billion in the third quarter. We expect further recaptures in subsequent quarters as well. Moreover, the cost per failure has trended downward since last year. Given this, ABA expects total costs from bank failures to be around $25 billion this year, far less than last year's total of over $37 billion. The FDIC has already rescinded the 3 b.p. increase expected in 2011 and beyond because these costs are falling more dramatically than expected. We would also note that insured deposits have ***declined*** over the last two quarters, which pushed the reserve ratio higher than FDIC had projected using a 5 percent annual growth rate. Finally, we expect little or no losses on the bond guarantee from the FDIC's Temporary Liquidity Guarantee Program. Thus, the $9.4 billion in revenue collected under the program, which will be added into the Deposit Insurance Fund in late 2012, will give another significant boost to the reserve ratio – and move forward the recapitalization to 1.35 percent by several quarters. Thus, we believe that it is more likely than not that, as the current failure cycle winds down over the next several years, the fund will build more quickly than currently estimated by FDIC as the number and costs of bank failures go down significantly.

The proposal sets forth a high designated reserve ratio and an aggressive premium schedule to meet that target ratio. Although little data were provided by FDIC to assess the pace of growth of the reserve ratio after it exceeds 2.00 percent, ABA believes that the assumptions may also be too pessimistic. We will discuss more fully the factors that suggest to us that the proposed Designated Reserve Ratio is much higher than can

[1] ABA's estimates use the failure cost pattern from 1993 – 2007, conservative estimates of growth of deposits and interest income, and the FDIC's rate changes at various reserve ratio levels.

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be supported given the recent and planned changes in law and regulation. But equally important to the question of what level is ultimately desired is the pace for achieving that level.

For example, setting an extremely high premium rate to drive the fund to any reserve ratio in only a few years would be unacceptable for the obvious reasons that the it would come while the economy was still struggling to establish a sustained recovery and would result in a significant drag on credit availability. Similarly, too slow a premium would not have the fund growing at a reasonable rate to build the fund to a level necessary to withstand another downturn. Thus, we think it is particularly important to have a full discussion about the ***pace*** of growth of the reserve ratio and the premium rates necessary to achieve a target ratio. ***Thus, we strongly recommend that once the fund reaches 1.35 percent, the FDIC reevaluate the rate schedule, reevaluate the designated reserve ratio and time frame to reach it, and solicit public comment before any schedule is made effective.***

III. The Proposed Target Fund Size Does Not Adequately Account for the Economic Impact on Communities

FDIC proposes a minimum Designated Reserve Ratio of 2.00 with the fund growing over 2.50 percent. The justification presented is that such levels would have prevented the reserve ratio from falling below zero in the last two major bank failure cycles. Such a high target level does not adequately consider the economic impact on banks and their communities. Certainly, in setting the Designated Reserve Ratio, the FDIC Board must consider the risk of losses, economic conditions, and preventing sharp swings in assessment rates. The Board must also consider "any other factors…consistent with these three factors" – the most important being the economic consequences of excess premium payments on credit and other services in banks' communities.

The difference between a reserve ratio of 2.00 and 2.50 percent is $27 billion (using June 30, 2010 data). An appropriate evaluation of the economic impact on credit and other services requires that we consider, for example, the number of small loans to businesses or individuals that may never be made if excessive funds are pulled from banks in order to boost the FDIC fund up to ever higher and higher levels. We believe that the FDIC premium rates – together with the substantial amount of interest income on such a large fund – will keep the reserve ratio rising even after 2.50 percent. And should the reserve ratio fall back below 2.50, the higher rates (which under the proposal are in effect from 2.00 percent to 2.50 percent) would be reinstated. This has the effect of keeping the reserve ratio at a minimum of 2.50 percent – ***thereby effectively establishing 2.50 as a new floor.***

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IV. The Proposed Target Fund Size is Inconsistent With New Laws and Regulations

The proposed high minimum Designated Reserve Ratio of 2.00 percent (and growing beyond 2.50 percent) does not take into account several important factors, including changes in the Dodd-Frank Act, increasing capital standards both domestically and globally, the historical impact of over-reserving for possible bank failures, and the magnitude of interest income generated at high reserve-ratio levels. ***These factors suggest a target reserve level considerably less than that in the proposal***.

Changes Made in the Dodd-Frank Act Reduce FDIC Exposure to Loss
Many provisions of the Dodd-Frank Act are designed to reduce the number of bank failures and the cost to the FDIC. These include the strengthening of prudential standards including capital, liquidity, risk management requirements, credit exposure, concentration limits, and stress tests for large banks, changes in resolution authority (including broad back-up examination authority and living wills for large banking firms, and the impact of the Financial Stability Oversight Council which is intended to avert severe economic dislocations.

Such factors should not be disregarded. Nor can the ineffectiveness of previous laws be reason to assume the current changes are doomed to be effective and would have no impact on bank failures and failure costs. Certainly, no one should dispute the fact that the changes made in the FDIC Improvement Act of 1991 (FDICIA), following the bank failures in the late 1980s and early 1990s, were not as effective in anticipating or stemming the failures in this current cycle, as had been hoped when these statutes were enacted. However, to assume no impact from recent changes is to repudiate key provisions of the Dodd-Frank Act. A primary goal of the Dodd-Frank Act was to ***prevent*** the same failure cycle we are currently experiencing. Thus, without explicit recognition of these changes, the designated reserve ratio will be far higher than is necessary.

Higher Capital Standards Reduce the FDIC's Exposure to Loss
The proposed designated reserve ratio of 2.00 percent is too high for other reasons as well, particularly the recent efforts – both in DFA and elsewhere – to raise the level of capital significantly for all banks. Chairman Bair reiterated her desire to implement stronger capital requirements in a recent interview: "It's our role. Capital, capital, more capital."[2] Higher domestic capital standards are also consistent with the global effort – through Basel III – to raise all capital levels particularly for large international banks, (including the concept of a buffer of capital above and beyond the regulatory standards). Once again, the higher levels of capital make it much less likely that a bank will fail, and reduce the cost to the FDIC of those that do fail. Such an important factor must be built into the FDIC's analysis and we believe reduces considerably the level of funding necessary to meet future FDIC needs.

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[2] Barb Rehm, "*Endgame for Bair is No Less Audacious*," **America Banker**, November 18, 2010.

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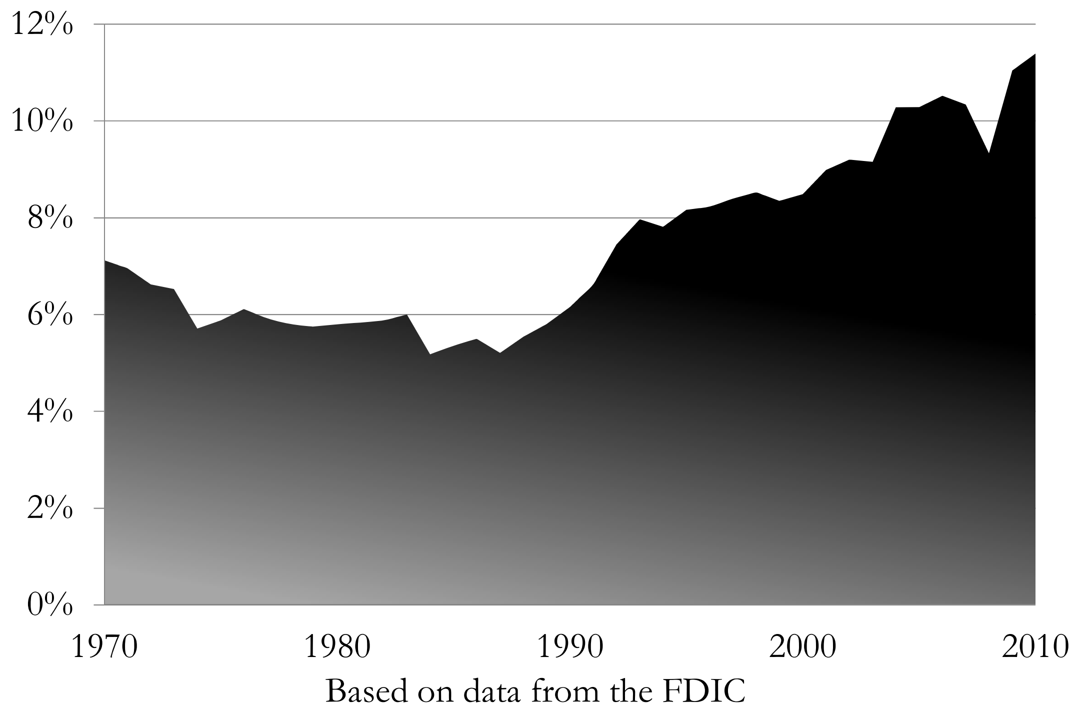

Even today, it is notable that the capital-to-asset ratio of the banking industry is at the highest level since the 1930s. While there are clearly banks that remain troubled – reflecting, of course, the severity of the downturn in their local communities – the overall financial condition of the industry is improving and the expectation of failure over the mid-term is declining quickly.

Historical Over-Reserving Must Be Taken Into Account When Setting the Reserve Ratio

The FDIC analysis does not consider the historical impact of over-reserving in troubled periods. For example, the FDIC's analysis ignores the fact that the $16.3 billion nadir of its insurance fund in 1990 reflected $12.9 billion of reserves that were recaptured over the following years. Thus, the fund would not have needed in reality to be at 2.31 percent to keep the reserve ratio positive as the FDIC analysis suggests. The recent deficit of $20.9 billion in 2009 in the insurance fund was the result of $44.0 billion of reserves. While it does not appear that the over-reserving has been as dramatic in this case as in 1991, the recapture of $6.2 billion of reserves in the last two quarters suggests some material over-reserving. Incorporating these factors suggests a lower the level of funding required than that presented in the FDIC proposal.

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Interest Income at High Reserve Levels Will Offset a Significant Amount of FDIC Expenses

The FDIC analysis does not consider what would happen in terms of earnings on the fund should the fund grow to 2.00 percent or larger. A fund of that magnitude generates a large amount of interest revenues. For example, over the period of FDIC's analysis, 1950 to the present, interest and securities gains/losses on the fund's portfolio of Treasury securities produced an average revenue equivalent to about a 9 basis point annual assessment on all banks. Combined with the premium revenue which is expected to be assessed every quarter, the reserve ratio is likely to grow very quickly.

This becomes particularly important during periods of stability and low insurance costs. For example, over 1993-2007, the cost of bank failures was equivalent to an average annual premium of about 0.5 basis points. An additional 3.5 basis point assessment would have been sufficient to cover FDIC operating expenses and maintain the fund reserve ratio. Had the fund been maintained at a 2.00 percent reserve ratio, the Treasury portfolio would have yielded the equivalent of an 8.5 basis point annual assessment. Thus, the securities portfolio ***alone*** would have produced about 4 basis points – ***$3 billion*** on the current assessment base – more than needed to maintain the fund reserve ratio. And since all banks would be assessed premiums in addition to the excess portfolio revenues, the fund would surely grow rapidly. The result would be an insurance fund growing to a scale that cannot be justified based on historical experience.

V. Disparities Between Credit Union and Bank Deposit Insurance Fund Size Should Be Considered When Setting the Long-Term Reserve Ratio

The National Credit Union Share Insurance Fund (NCUSIF) has a statutory limit on the size of its fund at 1.50 percent. Any amount above this limit must be rebated back to credit unions. In setting a target size for its insurance fund, the FDIC should consider the equity and competitive implications of assessing premiums on banks to bring the fund to a level considerably higher than 1.50 percent. Given that both funds offer identical protection for depositors and both enjoy the full faith and protection of the federal government, such a disparate treatment – which presents significantly higher costs on banks in order to reach a very large reserve ratio – is not appropriate and would create unintended consequences.

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Conclusion

The banking industry knows the importance of deposit insurance to our customers and our vital role in providing loans and other financial services in communities across this nation. Understanding ***both*** of these roles is central to the setting of any long-term level for the FDIC fund.

Certainly, no one can predict when the next economic downturn might occur and what level of bank failures might accompany that circumstance. But how ***quickly*** any level of funding is achieved very much depends on the assumptions of failures ***between*** cycles. By not looking at the typical cycle, the premium rate necessary to reach any arbitrary designated reserve ratio is greater than had a more reasonable pattern of expected losses been assumed. Therefore, it is extremely important that the FDIC monitor the progress toward rebuilding the fund and ***adjust premiums downward*** should the fund be growing faster than expected.

We believe the principles set forth in the letter should help guide the FDIC in finding the right balance that meets the agency's financial needs yet does not impose undue financial hardship on banks and their communities.

Sincerely,

Chief Economist